BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001

Docket No. R2000-1

POSTAL RATES AND FEE CHANGES, 2000

INITIAL BRIEF OF ALLIANCE OF NONPROFIT MAILERS

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The Alliance of Nonprofit Mailers ("ANM") respectfully submits this initial post-trial brief.

SUMMARY

ANM is a co-sponsor with a coalition of periodicals mailers of a brief on the costs of periodicals class mail, and co-sponsor with a larger group of mailers of a brief on the Postal Service's revenue requirement. This supplemental brief deals with a single additional issue: whether the costs of processing flat-shaped mail claimed by the Postal Service for the rate case test year have been inflated by the Service's underinvestment in flat shorting machines and facilities.

The record in this case shows that the Postal Service has grossly under-invested in the equipment, facilities space, and R&D needed for efficient automated process of non-letter-shaped mail. This underinvestment has needlessly inflated the labor costs—and, on balance, the total costs—of processing periodicals class mail. The Postal Service has failed to offered any adequate justification on the record for this phenomenon. Accordingly, the "honest, economical and efficient management" standard of 39 U.S.C. § 3621 requires exclusion of the needlessly high costs from the

costs attributed to periodicals mail, and from the overall test year revenue requirement. To give the Postal Service the benefit of the doubt, and avoid any possible double counting, ANM suggests that all programmed test year cost savings from the AFSM 100 for these subclasses of periodicals mail be offset against this remedy.

ARGUMENT

I. THE POSTAL SERVICE'S FAILURE TO MAINTAIN ECONOMIC AND EFFICIENT LEVELS OF INVESTMENT IN FLAT SORTING EQUIPMENT AND FACILITIES HAS INFLATED BOTH THE TEST YEAR REVENUE REQUIREMENT AND THE COSTS ATTRIBUTED TO PERIODICALS MAIL.

A. Inadequate USPS Capital Investment In Automated Processing Has Needlessly Inflated The Cost of Processing Flat-Shaped Mail.

The record in this docket highlights a perennial conundrum in postal ratemaking: the persistence of increasing costs. In recent years, many large business enterprises in the United States and elsewhere in the industrialized world—including the Postal Service's customers and competitors—have achieved significant productivity gains and reduced their real (inflation-adjusted) operating costs by investing in computerized technology and downsizing their workforces. 22 Tr. 9616-17 (Haldi). By contrast, Postal Service unit costs—especially for periodicals and non-letter mail—have exceeded the rate of inflation by a wide margin. Moreover, rising costs have gone hand-in-hand with a long term slowdown in productivity growth: cumulative growth in total factor productivity has declined during each of the past three decades. *Id.* at 9617-19.

Perhaps the most fundamental reason for this phenomenon is the Postal Service's chronic underinvestment in up-to-date mail processing equipment, particularly for non-letter mail. This underinvestment has inflated the Postal Service's

test year revenue requirement—and the costs attributed to processing non-letter mail—to levels far above those consistent with economical and efficient management.

1. USPS spending on capital investment for processing flat-shaped mail has been grossly inadequate.

The Postal Service's capital spending on automated mail processing equipment, especially for flat-shaped mail, has been inadequate by any relevant measure during the past decade. Beginning in 1993, net investment (i.e., gross investment minus depreciation) declined precipitously, as the Postal Service's automation program virtually ground to a halt for several years. Moreover, after adjusting for inflation, net investment levels at the end of the decade were no higher than a decade earlier. 22 Tr. 9625-27 (Haldi).

This rate of investment is far below the levels achieved by the best-managed postal authorities in other advanced Western economies, and other capital intensive firms in the United States. It is also far short of the Postal Service's own modest capital spending goals, as set forth in its own planned capital spending commitments. *Id.* at 9628-29 (Haldi).

This chronic underinvestment has led to a severe shortage of mechanized and automated sorting capacity for periodical and other non-letter mail. The shortage of adequate capacity to sort flats on a flat sorting machine ("FSM") and the consequent need to sort flats manually are discussed repeatedly by the Postal Service's operations expert, witness Kingsley, and also by USPS witnesses O'Tormey and Unger. The testimony of these witnesses demonstrates that the Postal Service has for many years suffered a growing shortage of flat sorting capacity. For example:

- While it is envisioned that the AFSM 100 will ultimately replace the FSM 881s, the first phase of deployment is

primarily intended to supplement our existing flat sorting equipment *by providing needed flats sorting capacity.*[1]

- The FSM 1000 has helped reduce the volume of mail that is processed in manual operations.[2]

- There are also heavy volume periods where our existing shortfall in flats sorting capacity results in some flats... being processed in manual operations.[3]

- The AFSM will help reduce the overall amount of mail in manual operations *by providing needed additional FSM capacity.*[4]

- FSM 881s will be relocated to smaller sites *that do not have flats sorting equipment or lack sufficient flats sorting capacity today.*[5]

- Throughput of the AFSM 100 is approximately 2 to 3 times higher than that of the FSM 881... and *much of the distribution that is being performed manually in delivery units* will be automated in plants.[6]

- The utilization [of barcodes] in incoming secondary operations remains relatively low . . . and *it highlights the need for additional flats sorting capacity.*[7]

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[1] USPS-T-10 (Kingsley), page 11, lines 25-28 (emphasis added).

[2] *Id.*, page 12, lines 20-21.

[3] *Id.*, pages 13-14.

[4] *Id.*, page 14, lines 9-10 (emphasis added).

[5] *Id.*, page 13, lines 9-11 (emphasis added).

[6] *Id.*, lines 14-17 (emphasis added).

[7] *Id.*, page 14, lines 24-26 (emphasis added).

- *As the flat mail volume grew throughout the 1990s*, and as we began incoming secondary and automated processing, *it was difficult to eliminate capacity constraints.*[8]

- The main reason [why so many prebarcoded flats were not processed in automated operations] *was due to not enough flat sorting machine capacity*, which required the flats to be sorted manually.[9]

- Though some facilities may have the necessary flats sorting capacity, others do not, and a shortage of FSM capacity does exist, systemwide.[10]

- [W]e have enough capacity in our letter mail system. We have over 250 automated plants. We have plenty of delivery bar code sorter capacity. Where the shortage was [in the fall of 1998] is the significant shortage of flat capacity, and that is what we had to deal with. That hit us heavier and hit deeper . . . .[11]

- [O]ne of the big contributors to flat processing costs is a shortage of automation equipment capacity.[12]

The Postal Service admits that it will require the additional capacity of at least the first 175 AFSM 100s deployed. Since the capacity of one AFSM 100 is equivalent to about 2.6 FSM 881s, this means that the Service is short the equivalent

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[8] Response of USPS witness O'Tormey to ANM/USPS-ST42-6 (21 Tr. 8303-05) (emphasis added).

[9] Response USPS witness Kingsley to MH/USPS-T10-8 (5 Tr. 1691-92) (emphasis added).

[10] Response of USPS witness Kingsley to MH/USPS-T19(b).

[11] 21 Tr. 8347 (O'Tormey).

[12] 21 Tr. 8393 (O'Tormey).

of perhaps as many as 450 FSM 881s.[13] Such a shortage is inexcusable. 22 Tr. 9632 (Haldi).

The first flat sorting machines, the FSM 775s were deployed in 1982, and the last one was installed in 1988.[14] The FSM 775s were converted to FSM 881s in 1990-92 by changing the configuration in a way calculated to increase throughput. Thus, by 1986-88 the FSM 775/881s constituted an off-the-shelf, proven technology. Its cost and capabilities were both well-known to the Postal Service. 22 Tr. 9632 (Haldi).

The FSM775/881s were purchased to support expected volume growth only through FY 1992.[15] By 1992, however, when the Postal Service should have been ordering additional flat sorting capacity, it sharply cut commitments for new equipment to only 15 percent of Plan (see Appendix, Table A-2). Under the circumstances, it is not surprising that the Postal Service found itself progressively short of flat sorting capacity after 1992. At the same time, the failure to plan and procure additional FSMs so as to have adequate capacity during the years 1992-2000 has deprived periodical mailers of the benefits of efficient and economical management.[16]

The average cost of the last FSM 881 machines purchased was only $230,000.[17] FSM 881s equipped with a barcode reader (BCR) and an optical

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[13] Response of USPS witness Kingsley to ANM/USPS-T10-21 and 39 (5 Tr. 1570, 1589).

[14] Response of USPS witness Kingsley to ANM/USPS-T10-1 (5 Tr. 1551).

[15] 5 Tr. 1589 (Kingsley).

[16] 22 Tr. 9632 (Haldi); 5 Tr. 1551 (Kingsley).

[17] 5 Tr. 1579 (Kingsley).

character reader (OCR) cost approximately $290,000.[18] In the context of gross capital spending that ranged between $1.7 and $3.9 billion (22 Tr. 9619 (Hald)), additional flat sort capacity was clearly affordable.

Throughout the 1990s, the Postal Service has had ample borrowing authority that could have been used to purchase additional flat sorting capacity and build adequate-sized facilities.[19] In addition to, or instead of, acquiring more FSM 881s, the Postal Service could also have acquired more FSM 1000s, another off-the-shelf piece of equipment that was widely deployed in 1996-1998 at a cost of $425,000 per machine.[20]

The FSM 881 represents a more efficient and economical way to process flats than manual sortation, especially when equipped with a barcode reader. All FSM 881s were retrofitted with BCRs during the years 1992-1993.[21] Deployment of optical character readers to the FSM 881s began in 1998, and all 812 FSM 881s will be equipped with BCRs by 2001.[22] The FSM 881 is capable of 94-100 separations, whereas the typical manual flats case has only 60 separations. Thus by any reckoning, the FSM 881 has for years represented a more economical and efficient alternative than manual sortation. Yet for years the Postal Service has been forced to undertake more and more manual sortation of flats because it has failed to invest in and deploy

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[18] 5 Tr. 1580 (Kingsley).

[19] 2 Tr. 177-78 (Tayman).

[20] USPS-T10 (Kingsley), page 11, lines 6-17; 5 Tr. 1585 (Kingsley).

[21] 5 Tr. 1592 (Kingsley).

[22] 5 Tr. 1584 (Kingsley).

a sufficient number of flat sorting machines.[23] Importantly, this is the course that would have been followed by any firm that was motivated to reduce costs wherever it had been proven to be economic and efficient to do so. There is no need to speculate or second-guess. The FSM 881 and the FSM 1000 each represent a fully-developed technology, with known cost, capabilities and payoff.

The brunt of the costs of inefficient manual processing fall upon those nonprofit periodicals and other subclasses that lack sufficient volume to constitute the most efficient utilization of the inadequate supply of equipment. Through no fault of their own, these subclasses are too often the ones whose mail is systematically shunted to high-cost manual operations. This costly and inefficient triage, with its less-than-zero-sum consequences, would have been unnecessary if the Postal Service had made adequate investments in automated flat-sorting equipment. 22 Tr. 9634-35 (Haldi).

2. Chronic under-investment has also caused a wide-spread shortage of facility space for sorting equipment for non-letter mail.

Another consequence of underinvestment is the emergence of too many cramped and overcrowded postal facilities, which contributes both to higher costs and the inconsistent quality of service received by the nonprofit subclasses, as well as other subclasses. Construction and building purchase represented the second largest category of shortfalls from planned commitments. During the 12-year period 1988-

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[23] In prior cases (Docket Numbers R94-1 and R97-1) witness Stralberg observed the extensive number of flats that were manually sorted and hypothesized that such labor represented "automation refugees." The Postal Service has denied the automation refugee hypothesis, and insisted that such manual sortation was necessary to meet service requirements. To the extent the Postal Service is correct, there has been a serious "automation shortfall." 22 Tr. 9634 n.40 (Haldi)

1999, only 74.4 percent of planned commitments for construction and building purchase were actually made. The record—including the candid testimony of the Postal Service's own witnesses—confirms that the shortage of space at Postal Service plants has inflated the cost of processing flat-shaped mail. *See* 22 Tr. 9635-37 (Haldi) (citing testimony of USPS witnesses).

3. USPS spending on research and development has also been inadequate.

Another neglected area of the operating plan is research and development. Postal Service spending on research and development was curtailed sharply beginning in 1993, and has remained at a comparatively low level since then. These low levels of investment in R&D are undoubtedly a major reason why the Postal Service remains so labor-intensive. 22 Tr. 9637-38 (Haldi).

4. Knowledgeable outside observers have confirmed the inadequacy of USPS investment levels.

Many participants in the Postal Service's Blue Ribbon Committee agreed in their 1997 report that the Postal Service's level of capital investment was grossly inadequate. Observed one participant, "I think the Postal Service is budgeting something like six to eight percent" of its revenue on capital investment. "That's not enough." *Finding Common Ground*, p. 36. "Automation . . . has to continue to grow," noted a direct-mail manager. *Id.*, p. 37. "The Postal Service should expand its investment in technology to make the necessary measurements that a quality program needs," added a university mail manager. *Id.*

Based on the projections of future-Postmaster Henderson that the Postal Service "would require a yearly investment of $4 billion at a minimum return-on-investment just to keep pace with current USPS programmed labor cost increases,"

the Blue Ribbon Committee recommended an "expanded capital investment program." *Id.*, p. 40. The Committee also urged the Postal Service to establish a USPS task force to make recommend "more appropriate capital spending targets," and to "identify specific opportunities within the Postal Service for additional investment." *Id.* at 44.

In Fiscal Year 2000, the Postal Service projects that its net investment as a percentage of operating revenue will be *lower* than in 1997—2.6 percent vs. 2.7 percent. *See* 22 Tr. 9627 (Haldi) (citing USPS reports).

B. The Postal Service's Excuses for Under-investment Do Not Withstand Scrutiny.

The Postal Service's traditional excuses for underinvestment do not withstand scrutiny. In the past, the Service has blamed its underinvestment on borrowing constraints, contractual rigidities in the supply of labor, and a shortage of experience supervisors. These Service has apparently abandoned these explanations in the present case, and necessarily so. The Service has substantial unused borrowing capacity, and has ample flexibility to down-size its workforce. *See* 22 Tr. 9643-46 (Haldi). Instead, the Postal Service suggests that its investment levels were justified by cost-benefit analysis, and that no other opportunities for additional investment would have been profitable. Neither claim is supported.

(1) The Postal Service has offered no cost-benefit analysis or other evidence indicating that its actual levels of investment in flat-sorting equipment have been efficient or adequate, and no such analysis apparently was ever performed. To the contrary, the Service has made a point of pride out of its failure to "analyze whether the Postal Service's operating plan is actually cost minimizing."[24]

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[24] Response to AAP/USPS-1 (21 Tr. 8611). USPS witness Tayman likewise admitted that "I am not aware if any [cost-benefit analysis] has" been performed to

Moreover, the enormous returns predicted (and apparently achieved) by the Postal Service on its existing investment in sorting equipment for non-letter mail are powerful evidence that the Service has failed to exhaust all profitable opportunities for investment of this kind. Received microeconomic theory teaches that an economically and efficiently managed firm should expand investment in labor-saving, cost-reducing equipment to the point where the cost savings and increased revenue generated by the last dollar of investment produce a return equal the hurdle rate for the investment. The very large returns on investment apparently achieved by the Postal Service from its limited investments in automated processing of flat-shaped mail confirm that investments in sorting equipment for non-letter mail have not come close to this equilibrium point. 22 Tr. 9639-41 (Haldi) (citing USPS testimony and data).

(2) Witness Kingsley contended that "a production line [for the FSM 775/881] did not exist after FSM 775 deployment was completed in 1992 and considerable costs are incurred to restart a production line." 5 Tr. 1589-91 (Kingsley). The Postal Service's failure to buy more FSM 775s and 881s cannot be blamed on this factor, however. 22 Tr. 9646-47 (Haldi).

The shortage of FSM capacity did not occur overnight. Witness Kingsley acknowledges that the FSM 775/881s were planned to handle anticipated needs only through 1992. 5 Tr. 1590-91 (Kingsley). That restarting a production line entails considerable fixed costs is a well known fact of economic life that should have been obvious to Postal Service management in 1988-1992. Moreover, since the Postal

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test the possibility that a larger amount of investment in flat-sorting equipment would have been beneficial. 2 Tr. 442-44 (Tayman). Mr. Tayman admitted that determining whether "a larger investment in capital of this kind . . . would have had incremental benefits that exceed the incremental costs" would have required a cost benefit analysis. *Id.* at 442 & 454, lines 16-22.

Service knew full well that it was the only customer for flat sorting machines, it has no excuse for not anticipating that the production line would be closed down after the last FSM 775s were delivered. During that same period, management should also have been aware that (i) there were no plans to add FSM capacity to handle increased flats volume after 1992, and (ii) an improved, next-generation flat sorting machine was nowhere close to availability. Before the first FSM 775s were purchased, the Postal Service faced an obvious trade-off between ordering more FSMs at that time, and thereby or subsequently (*e.g.*, within a few years, and well before a critical shortage of capacity existed) paying the additional cost of restarting the production line, depending on which course was more economic. But it did neither. 22 Tr. 9646-47 (Haldi).

(3) Witness Kingsley stated that "The limited long-term value of the FSM 775/881 is supported by the expected replacement of FSM 775/881s starting in FY 2001 with the AFSM Phase 2 deployment." However, the advent of the AFSM 100 as a realistic alternative to earlier machines by FY 1998-99 was no excuse for management inaction extending over a period as long as 10 years. 22 Tr. 9648 (Haldi).

(4) In his rebuttal testimony, USPS witness Dowling asserted that the pace of flat-processing automation was constrained not by Postal Service investment levels, but by the limited availability of technology. His testimony is entitled to little weight. On cross-examination, he admitted that he was unaware that the unit costs for processing flats mail rose from 1993 through 1998. 46A Tr. 20483. He initially professed to be ignorant of the amount by which USPS capital investment in flat sorting equipment fell short of the Service's own investment plans in the 1990s. *Id.* at 20485. Confronted with the portion of Dr. Haldi's testimony summarizing the magnitude of the Service's investment shortfalls, he ultimately conceded that the Service's investment in automated flat-sorting equipment fell short of plan by

approximately $500 million in the 1990s. *Id.* at 20486-87. Mr. Dowling professed to be unaware that the management shakeup at Postal Service headquarters during 1992-95, the beginning of Postmaster Runyan's tenure, had a significant responsibility for the shortfall in capital expenditures on mail processing equipment during the same period--directly contradicting the testimony of USPS witness Tayman. *Id.* at 20488-89.

(5) In his rebuttal testimony, Mr. Dowling also contended that the Service's shortfall in capital investment for flats was due to a downturn in non-carrier route flats volume. 46A Tr. 20475 (Dowling). On cross-examination, however, he conceded that the downturn in volume lasted only one year (1991), yet the downturn in capital spending lasted through 1995. *Id.* at 20487.

(6) Finally, Mr. Dowling conceded that the Postal Service first saw a prototype of the Alcatel machine that ultimately became the AFSM 100 in 1992, and first began testing it in 1994 or 1995--more than *six years* before the rate case test year. *Id.* at 20499, 20505-06. By 1994, Canada Post was already deploying the Alcatel machine to process flats. *Id.* at 20506. Had the Postal Service acted with similar expedition, the AFSM 100 could have been fully deployed in the United States far before the beginning of the rate case test year.

C. Remedy

The Postal Service may not charge mailers and consumers whatever costs it incurs, regardless of their profligacy or inefficiency. Rather, the Service may recover only the revenue needed to cover the costs of providing an appropriate level of service "under honest, efficient, and economical management." 39 U.S.C. § 3621. The standard of "honest, efficient, and economical management" requires disallowance of needlessly high costs, even if actually incurred by the regulated firm. *See, e.g., D.C. Transit System, Inc. v. Washington Metropolitan Area Transit Commission,* 466 F.2d

394, 407-10 & n. 101 (D.C. Cir.) (citing cases), *cert. denied*, 409 U.S. 1086 (1972); *Democratic Central Committee of D.C. v. Washington Metropolitan Area Transit Commission*, 485 F.2d 886, 903-08 (D.C.Cir. 1973) (standard of "honest, economical and efficient management" does not entitle regulatee to the revenue of a "high-cost plus company").

It is not "economical" or "efficient" to continue relying on obsolete mail processing equipment (or even manual processing) when the incremental savings from deployment of modern automated equipment gains are likely to exceed the incremental capital and operating costs. As Justice Brandeis observed,

> Efficiency and economy imply employment of the right instrument and material as well as their use in the right manner. To use a machine, after a much better and more economical one has become available, is as inefficient as to use two men to operate an efficient machine, when the work could be performed equally well by one, at half the labor cost.

St. Louis & O'Fallon Ry. v. United States, 279 U.S. 461, 517 (Brandeis, dissenting). Accordingly, the Commission should (1) adjust the unit cost of Periodicals downward to what that cost would be if the Postal Service had made anywhere near the appropriate investments in time for use during the test year, and (2) make a corresponding adjustment in the revenue requirement.

The Postal Service has asserted in recent rate cases that the efficiency of its actual operations and accrued costs is completely irrelevant to postal ratemaking. In Docket No. R97-1, USPS witness Panzar stated:

> [T]he efficiency of the Postal Service operating plan is not an issue for the analyst. *As long as it is given that postal services will be produced following Postal Service practices and procedures, the relevant marginal and incremental costs for pricing purposes are those calculated based on the Postal Service' operating plan.*

USPS-T-11 (Docket No. R97-1) at 17 (emphasis in original).

The Postal Service has been equally assertive in this docket. Invoking Dr. Panzar's testimony in Docket No. R97-1, the Service boasts that "[n]o postal witness in this case has attempted to analyze whether the Postal Service's operating plan is actually cost minimizing." Response of USPS to AAP/USPS-1 (21 Tr. 8611).

In Docket No. R97-1, the Commission expressed skepticism that economic efficiency could be dismissed so readily. Addressing Dr. Panzar's testimony, the Commission noted that "the usual economic definition of a cost function . . . derives the function C(M,w) by selecting labor and other inputs to *minimize* the cost of the vector of mail volumes, (M), at the given prices, (w)." R97-1 Op. & Rec. Decis. (May 11, 1998) at ¶ 4032.

The Commission went on to analyze some of the consequences of basing cost attributions on the costs of inefficient operations. *Id.* at ¶ 4031-52. For example, without cost minimizing behavior, "the marginal cost of any product becomes subject to the whims of the firm's management and does not provide an accurate measure of the efficient cost of society's resources to produce an additional unit of any of the firm's outputs." *Id.* at ¶ 4046. "Because the marginal costs of a firm not constrained to minimize total production costs in producing its output is endogenous to its choice of an operating plan, these marginal costs are of limited use in setting rates." *Id.* at ¶ 4049.

The Commission's refusal to abdicate its duties under 39 U.S.C. ¶ 3621 is essential; otherwise, the Postal Service and its Governors would have a license to formulate and implement any operating plan whatsoever, no matter how inefficient, year after year, and pass on to mailers all the resulting costs.

A basic optimization problem faced by every firm is the selection of a cost-minimizing mix of inputs for producing a given quantity and quality of outputs at a given set of input prices. How much money, for example, should be budgeted for labor vs. machinery? How often should a firm replace older machinery with newer,

more productive models? Every firm, large or small, continually faces variations of these questions. Firms that produce a given volume and quality of outputs with a cost-minimizing mix of inputs are said to be operating on the efficiency frontier or production-possibility frontier. Firms that adopt a more costly mix of inputs are said to be operating inefficiently. 22 Tr. 9622 (Haldi).

In competitive markets, there is no need for any regulator to second-guess the management efficiency of the incumbent firms. The invisible hand of competition performs this task, rewarding efficiency and punishing its absence. All other things being equal, firms with efficient mixes of inputs are able to attain greater profitability than higher-cost rivals, or to attract more business by lowering prices. Firms that fail to maintain an efficient mix of inputs—including firms that underinvest in maintenance, improvement and modernization of their physical plant—sooner or later improve their efficiency, or exit the market, or get acquired by other, more profitable firms. *Id.*

Market power, however, tends to insulate incumbent firms from this competitive discipline. The greater the market power, the greater the inefficiency that can arise, and the longer the quiet life that allows it to persist. At the extreme is an organization like the Postal Service, which enjoys a legal monopoly over much of its business, and is the last remaining nationwide monopoly. That this giant enterprise has not even "attempted to analyze whether [its] operating plan is actually cost minimizing" is evidence of great monopoly power indeed. 22 Tr. 9623 (Haldi) (quoting 2 Tr. 442-44 (Tayman)).

When competition fails to provide a reliable check on the efficiency of regulated monopolies, government must replicate this safeguard through the ratesetting process. Hence, the legal directive to limit the Postal Service's revenue to the levels justified by "honest, economical and efficient" management has only one sensible economic meaning: the Postal Service may recover costs from ratepayers

only if efficiently incurred. Just as effective competition prevents firms from recovering the costs of suboptimal, uneconomic and inefficient management, so must the regulatory process disallow recovery of needlessly inflated costs by the Postal Service. 22 Tr. 9623 (Haldi).

The standard here is not the perfection of 20/20 hindsight. Even the best managers must work with incomplete data and uncertain projections. Fairness entitles Postal Service management decisions to a certain amount of deference. But when management neglect generates massive excess costs, year after year, the standard of "honest, economical and efficient management" does not allow the Commission simply to rubber-stamp the excess as part of the Service's revenue requirement. The costs of such inefficiency must be excluded from the Service's overall revenue requirement, the attributable costs of individual classes or categories of service, and the "relevant marginal and incremental costs for pricing purposes." Ignoring the possibility that Postal Service costs have been inflated by inefficiency would abdicate the Commission's responsibility as a consumer protection agency. 22 Tr. 9623-24 (Haldi).

The Postal Service's failure to produce (and, apparently, to create) the necessary data thwarts precise quantification of the full amount of the costs needlessly generated by the Service's underinvestment. Nevertheless, the costs clearly are large. The record shows, as every Postal Service witness on the issue conceded, that manual sortation of flats is undertaken as a last resort because it is more costly than when done on FSMs. 22 Tr. 9650-51 (Haldi).

Moreover, a conservative analysis does not require the Commission to estimate by how much the efficient deployment of automated equipment would have decreased the costs of mail processing costs: it sufficient to know that inflation-adjusted unit costs would not have increased. Barring war, revolution or other major dislocations, the stock of technology and intellectual capital available for deployment

in any economy normally increases, or at a minimum remains constant. Stated otherwise, the technological production possibility frontier does not regress toward the origin; it either remains static or expands. *Id.* at 9651.

Hence, barring any drastic shift in the composition of a mail class, or a significant change in its makeup that would make it more difficult or costly to produce, there is no reason why the real (i.e., inflation-adjusted) cost of processing the mail would increase under efficient management. Accordingly, a conservative rule of thumb is that any persistent and unreasonable increase in the inflation-adjusted unit cost of processing a subclass of mail from one rate case to the next should be attributed to internal inefficiency, unless the Postal Service demonstrates otherwise. *Id.*

With respect to periodical mail, the Postal Service has made no such showing. The two Postal Service witnesses tendered in response to the Order No. 1289, Dennis Unger and Walter O'Tormey, candidly admitted that they had no explanation for the significant and paradoxical increase in such costs since 1993. "Why the costs for periodicals specifically has gone up, I can't answer," Mr. Unger conceded. 21 Tr. 8279, 8282 (Unger). The testimony of USPS witness Walter O'Tormey was in the same vein. *See* 22 Tr. 9651-53 (Haldi) (discussing Unger and O'Tormey testimony).

Between 1993 and 1998, the wage-adjusted increase in the average unit costs of processing periodicals mail *increased* by approximately 1.13 to 1.30 cents per piece, while the average unit cost of processing single-piece First-Class Mail, where investment for automated letter sorting capacity has been less inadequate (and no major capacity shortfall is evident), *decreased* by 0.2 to over 0.5 cents per piece. As discussed previously, the Postal Service had all the financial resources necessary to pursue automation of flats processing with as much vigor as it pursued automation of letter mail. Had it done so, it is reasonable to presume that, at a minimum, wage-

adjusted unit costs should not and would not have increased, and might even have decreased.

A conservative estimate of the increase in the unit cost of periodicals brought about by the failure to make adequate investment for foreseeable needs is 1.2 cents. As shown in Dr. Haldi's testimony for ANM, this amounts to about $94 million for all Regular Rate, Nonprofit and Classroom periodicals mail in the test year. In light of the Postal Service's failure to provide any reasoned explanation for the run up in mail processing costs during this period, the entire amount should be disallowed as inconsistent with economic and efficient management. To give the Postal Service the benefit of the doubt, and avoid any possible double counting, ANM suggests that all programmed test year cost savings from the AFSM 100 for these subclasses of periodicals mail be offset against this remedy. *See* 22 Tr. 9689 (Haldi).

CONCLUSION

For the foregoing reasons, ANM respectfully requests that the Commission recommend rates that reflect the adjustments proposed in this brief, and in the two coalition briefs that ANM has co-sponsored.

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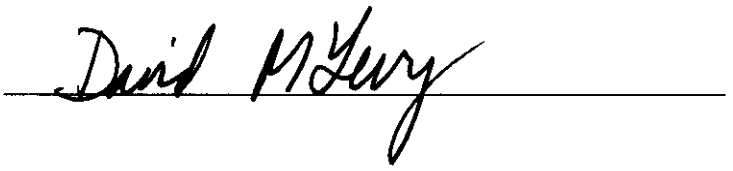
CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document on all participants of record in this proceeding in accordance with section 12 of the Rules of Practice.



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